

**Office of Chief Counsel  
Internal Revenue Service**

**memorandum**

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CAFisher

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to: Lee Poullard, Technical Assistant,  
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from: Associate Area Counsel, LM:HMT, Cleveland, Ohio

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subject: **Aerospace ISP  
Intranet Website FAQs - Cascading Research  
Credit and B&P Costs  
U.I.L. Nos. 41.51.02;41.51.09;460.03-07;  
460.03-07;263A.03-02**

This responds to your request for review of certain "Frequently Asked Questions" (FAQs) to be posted to the Aerospace ISP IRS Intranet website. Our recommended revised FAQs are provided below. These revisions are provided pursuant to the 10-Day Post Review procedures of CCDM (35)3(19)4(4), as these FAQs are limited to primarily well-settled principles of law. Accordingly, a copy of this memorandum has also been provided to the Office of Chief Counsel for review and comment. We are also providing a copy Dan Rosen, counsel to the Research Credit ISP. We will advise you of their comments as soon as they are received.

Cascading Research Credits

Overview

Taxpayers can claim a tax credit for qualified research expenses paid or incurred in a trade or business. Sec. 41. This credit is equal to the sum of (1) 20% of the excess of the taxpayer's qualified research expenses (QREs) for the taxable year over the "base amount" and (2) 20% of the taxpayer's basic research payments. Sec. 41(a). QREs include amounts paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer for contract research expenses (Contract Research QREs) and in-house research expenses (In-House QREs). Sec. 41(b)(1).

Contract Research QREs are 65% of the amount paid or incurred by the taxpayer to any person, other than an employee of the taxpayer, for qualified research. Sec. 41(b)(3). In-House QREs include, among other things, amounts paid or incurred for supplies used in the conduct of qualified research (Supply QRE). Sec. 41(b)(2)(A)(ii). Certain research activities are specifically excluded from the definition of qualified research. Because these excluded activities are not qualified research, amounts paid or incurred in the conduct of an excluded activity are not QREs. Research that is funded by any grant, contract or otherwise by another person (or governmental entity) is an excluded activity. Sec. 41(d)(4)(H).

Q.1. What are cascading research credits?

A.1. The term "cascading research credits" is sometimes used to refer to situations where more than one taxpayer claims the research credit with respect to the same item. This can happen when a prime contractor subcontracts out the design, development, manufacture and delivery of a supply to be used in the qualified research of the prime contractor. For example, assume that an aircraft manufacturer, as the prime contractor, enters into a contract with the Government for the design, development, manufacture and delivery of a developmental jet fighter. The contract specifications for the aircraft windshield can only be accomplished through the design and development of a new lightweight material. The prime contractor subcontracts the design, development, manufacture and delivery of the new material to an unrelated subcontractor. The prime contractor will incorporate the material into the aircraft when received from the subcontractor. To the extent that the prime contractor uses the new material in qualified research, the cost of the new material may be a supply QRE. The subcontractor that designed, developed, manufactured and delivered the new windshield to the prime contractor also claims the research credit with respect to the research expenses it incurred in fulfilling its contract with the prime contractor. The research credit with respect to this material has thus "cascaded" from the prime contract level to the subcontract level.

Q.2. Is there an express prohibition against cascading

research credits?

A.2. The cascading of research credits is not per se prohibited by section 41 or the regulations thereunder. Nonetheless, there are rules on the availability of the research credit which may restrict taxpayers at different levels from claiming the credit with respect to essentially the same research.

Q.3. How do these rules work?

A.3. At the prime contractor level, the primary issue is whether the component is a supply to be used in the prime contractor's qualified research. This issue is explored in more detail below in Q. & A. 4. If it is in fact determined that the component is a supply expense, then the rules restricting the prime contractor from treating the expense as a qualified research expenses are not reached at the prime contractor level.

Remember, amounts paid or incurred to acquire property of a character subject to the allowance for depreciation are not QREs.

Further, if the component is found to be a contract research expense, then it must be determined whether the item can be claimed as a Contract Research QRE of the prime contractor. To qualify as a Contract Research QRE, the expense must have been paid or incurred **for the performance of qualified research on behalf of the taxpayer**. Treas. Reg. § 1.41-2(e)(2). An expense will not be "for the performance of qualified research," however, if the taxpayer, i.e., the prime contractor, does not have to bear the expense if the subcontractor's research is unsuccessful. Treas. Reg. § 1.41-2(e)(2)(iii). If payment for the research is contingent on success, then the prime contractor is considered to be paying for the product or result of the research, and not for the performance of the research and the payment is not a contract research expense. Treas. Reg. § 1.41-2(e)(2).

This "contingent on success" requirement is mirrored at the subcontractor level by way of the funded research exclusion of section 41(d)(4)(H). Section 41(d)(4)(H) provides the general rule that QRE status is denied for research expenses to the extent the subcontractor's research is funded by any grant, contract, or otherwise by another person (or governmental

entity). The subcontractor's research efforts shall not be considered "funded," however, to the extent that the amounts payable under the contract are contingent on the success of the subcontractor's research. Treas. Reg. § 1.41-4A(d)(1). The "contingent on success" requirements at both the prime contractor and subcontractor levels work in tandem to offset each other, denying the research credit to one party and allowing it to the other with respect to the same research. If the prime contractor's payment for the subcontractor's research is contingent on the success of the research, then the expense is not a Contract Research QRE for the prime contractor, and is not funded research for the subcontractor. Conversely, if the prime contractor's payment for the research is not contingent on success, then the research qualifies as Contract Research QRE to the prime contractor and is funded research to the subcontractor.

Another rule restricting the cascading of research credits is based upon who retains the rights to the results of the research performed. At the prime contractor level, an item will be a Contract Research QRE if the qualified research is performed on "behalf of the taxpayer." Research is performed on behalf of the taxpayer if it has a right to the research results. Treas. Reg. § 1.41-2(e)(3).

At the subcontractor level, research will be considered fully "funded" if the subcontractor retains no substantial rights in the research, and the research expenses incurred by the subcontractor will not be QREs. Treas. Reg. § 1.41-4A(d)(2). If the taxpayer does retain substantial rights in the research, the research is considered "funded" only to the extent of the payments that the taxpayer becomes entitled to by performing the research. Treas. Reg. § 1.41-4A(d)(3).

Unlike the "contingent payment" rules, the rules regarding the rights to research at the prime contractor and subcontractor levels are not necessarily fully offsetting, in that it could be determined that a prime contractor has rights to the research while at the same time the subcontractor has substantial rights to the research. Qualified research can be performed on behalf of the taxpayer notwithstanding the fact that the taxpayer does not have exclusive rights to the results. Treas. Reg. § 1.41-2(e)(3). As a final note, it is possible that under these rules neither the prime contractor nor the subcontractor will be eligible for the research credit. This could happen where: 1) the prime contractor's

payment to the subcontractor is contingent on the success of the subcontractor's research (the prime contractor thus fails Treas. Reg. § 1.41-2(e)(2)(iii)); and 2) the subcontractor retains no substantial rights to the research (the subcontractor thus fails Treas. Reg. § 1.41-4A(d)(2)). See, T.D. 8251, 1989-1 C.B. 3, 4.

Q.4. How does one determine whether a component is a supply or a contract research expense?

A.4. A Contract Research QRE is 65% of any amount which is paid or incurred to any person (other than an employee of the taxpayer) for the performance of qualified research. Sec. 41(b)(3)(A). A Supply QRE, on the other hand, is not a payment for the performance of research on behalf of the taxpayer. Rather, a Supply QRE is broadly defined to include amounts paid or incurred for any tangible property, other than land (and improvements to land) or depreciable property, that is used in the conduct of qualified research. Sec. 41(b)(2)(A)(ii) and (C). These supplies must be used in the performance of qualified services - which includes services consisting of engaging in qualified research, or the direct supervision or direct support of qualified research. Treas. Reg. § 1.41-2(b)(1). Supply QREs include, for example, supplies used directly in experimentation, by a laboratory assistant in entering research data into a computer, or by a machinist in the fabrication of a part for an experimental model. H.R. Rep. No. 97-201, at 118 (1981). Supply QREs do not include indirect costs or general and administrative expenses, such as supplies used in accounting services. Treas. Reg. § 1.41-2(b)(1). Further, Supply QREs do not include parts to be installed on property of a character subject to the allowance for depreciation. As an example of an eligible Supply QRE, the regulations provide that extraordinary utilities expenditures used in qualified research are Supply QREs, however, ordinary utility expenditures are not eligible Supply QREs. Treas. Reg. § 1.41-2(b)(2)(ii).

There is no statutory support for the contention that a subcontract is for the purchase of supplies simply because it requires the subcontractor to deliver a component or hardware item. Rather, the definition of a Contract Research QRE, on its face, applies to "any" payment to a subcontractor for qualified research. Where the contract calls for services other than qualified services, only 65 percent of the portion

of the amount paid or incurred that is attributable to qualified services is a Contract QRE. Treas. Reg. § 1.41-2(e)(1).

Further, it is important not to be misled by arguments which are based upon the premise that an item must be a Supply QRE simply because it fails to satisfy the requirements of a Contract Research QRE. For example, the regulations state that "[i]f an expense is paid or incurred pursuant to an agreement under which payment is contingent on the success of the research, then the expense is considered paid for the product or result rather than the performance of the research, and the payment is not a contract research expense." Treas. Reg. § 1.41-2(e)(2). Taxpayers may attempt to rely on this to argue that they were not paying for contract research, but instead were paying for a "product or result," which was a supply.

#### Bid and Proposal Costs

##### Q.1. What are Bid and Proposal Costs?

A.1. Section 31.205-18(a) of the Federal Acquisition Regulations defines "Bid and Proposal (B&P) Costs" as the costs incurred for preparing, submitting, and supporting bids and proposals (whether or not solicited) on potential Government or non-Government contracts. The term does not include the cost of efforts sponsored by a grant or cooperative agreement, or that is required for the performance of a contract. Taxpayers typically report the following types of expenditures as B&P Costs:

1. Technical writing of the Projected Proposal Response;
2. Preparation of the Proposal Outline;
3. Planning, scheduling and managing the proposal process;
4. Conducting periodic meetings with the proposal team;
5. Establishing teaming/subcontractor arrangements;
6. Writing the Technical Proposal;
7. Writing the Management Proposal;
8. Writing the Cost Proposal;
9. Copying/editing/typing the Technical Proposal;
10. Copy/editing/typing the Cost Proposal;
11. Writing boiler plate sections of the various Proposals;
12. Preparing cost estimates and models;
13. Strategizing cost/price;

14. Completing non-technical administrative forms;
15. Revising the Cost Proposal for amendments to RFP;
16. Updating the Management Proposal - Best and Final Offer (BAFO);
17. Updating the Cost Proposal - BAFO;
18. Responding to customer questions re the BAFO;
19. Writing responses to Requests for Additional Information which modify or clarify the proposal;
20. Demonstrating technical or product capability as required by the Request for Proposal (RFP);
21. Revising the Technical Proposal for Amendments to RFP Statement of Work;
22. Revising the Management Proposal for Amendments to RFP Statement of Work.

However, the exact costs to be accumulated as B&P Costs is left to the contractor to determine, based upon its policies and procedures. Accounting for Government Contracts - Costs Accounting Standards, Anderson, Lane K.; Ch. 28.01[1], pg. 28-3; 48 CFR 9904.420-50(a).

Q.2. What is the proper tax accounting treatment of B&P Costs?

A.2. Long Term Contracts other than Service Contracts In the case of long term contracts other than for services, if the taxpayer reasonably expects to enter into a long-term contract in a future taxable year, the taxpayer must capitalize all costs incurred prior to entering into the contract that will be allocable to that contract, e.g., B & P Costs. If the contract is not awarded to the contractor, the contractor must account for these B&P Costs in that year (as a deduction or an inventoriable cost) using the appropriate rules contained in other sections of the Code or Regulations. Treas. Reg. § 1.460-4(b)(5)(iv).

Under the Unicap rules, a taxpayer must defer all B&P Costs paid or incurred in the solicitation until a particular contract is awarded. If the contract is awarded to the taxpayer, the bidding costs become part of the indirect costs allocated to the subject matter of the contract. If the contract is not awarded to the taxpayer, bidding costs are deductible in the taxable year that the contract is awarded to another party, or in the taxable year that the taxpayer is notified in writing that no contract will be awarded and that the contract (or a similar or related contract) will not be

rebid, or in the taxable year that the taxpayer abandons its bid or proposal, whichever occurs first. Treas. Reg. § 1.263A-1(e)(3)(ii)(T).

Long-Term Service Contracts Section 460's application is limited to contracts for the manufacture, building, installation, or construction of property which is not completed within the taxable year the contract is entered. Sec. 460(f)(1). As such, pure service contracts are not within the scope of section 460 and thus not subject to the cost allocation rules of Section 460(c) and Treas. Reg. § 1.460-4(b)(5)(iv) discussed above. In addition, service contracts generally do not involve produced property to which the uniform capitalization rules of section 263A apply. Typically, taxpayers take the position that B&P Costs incurred in connection with long-term service contracts are deductible period costs. However, whether B&P Costs incurred in connection with long-term service contracts are deductible currently under section 162 or must be capitalized under section 263 depends upon the particular facts and circumstances at issue, i.e., whether the B&P Costs result in the acquisition of an asset and provide significant long-term benefits. See, e.g., TAM 199952069.



Q.3. Can B&P Costs satisfy the definition of "qualified research expenses" for purposes of the Research Credit?

A.3. Section 41(a) provides for a credit equal to the sum of 20% of the excess of the taxpayer's "qualified research expenses" for the taxable year over the base amount, and 20% of the taxpayer's basic research payments. Section 41(d)(1) defines the term "qualified research expenses" as research

- A) with respect to which expenditures may be treated as expenses under section 174,
- B) which is undertaken for the purpose of discovering information-
  - (i) which is technological in nature, and
  - (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
- C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose relating to-
  - (i) a new or improved function,
  - (ii) performance, or
  - (iii) reliability or quality.

Qualified research does not include activities excluded under section 41(d)(4).

Given the nature of B&P Costs, it is difficult to conceive how they could satisfy the foregoing definition of qualified research expenses. Further, there is often relatively little time available to a taxpayer after it receives a Request For Proposal to actually submit its Bid and Proposal. Given this, it seems unlikely that the taxpayer would have the time to undertake any significant research during the Bid and Proposal period. However, see section 1.41-4A(d)(4) addressing independent research and development costs and bid and proposal costs and the exclusion for funded research.

Nonetheless, as indicated above, the particular items accumulated as B&P Costs are left to the contractor to

determine, based upon its policies and procedures. Thus, if engineering activities were conducted prior to or during the Bid and Proposal process, they may qualify for the research credit. Accordingly, a review of the taxpayer's Bid and Proposal effort should be conducted. In doing so, examiners should request and review the following:

- Taxpayer's definition of B&P;
- Taxpayer's B&P policy and accounting procedures manual;
- Review selected activities of the Bid and Proposal process to determine if they satisfy the requirements of section 41.

If you have any questions regarding the foregoing, please contact the undersigned at 216-522-3380, ext. 3106.

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